PETITIONER'S EXHIBIT 2-B.

Filing District—Massachusetts SN-IT-3

Treasury Department Internal Revenue Service

Office of Internal Revenue Agent in Charge Boston Division

140 Federal Street

Jan 7—1943

Talbot Mills, Faulkner Street, North Billerica, Massachusetts.

Registered Mail

Gentlemen:

You are advised that the determination of your income tax liability for the taxable year(s) ended September 30, 1940 declared value discloses a deficiency of $7,588.69 and that the determination of your excess-profits tax liability for the year(s) mentioned discloses a deficiency of $2,196.12 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiencies mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with the Tax Court of the United States for a redetermination of the deficiencies.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, Boston, Mass. for the attention of TMK:90-D. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiencies, and will prevent the accumulation of interest, since the interset period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

GUY T. HELVERING, Commissioner,

By T. N. Kenefick

Internal Revenue Agent in Charge.

Enclosures: Statement. Form of waiver. TMK:H.L:WM:c.

Boston Division

STATEMENT

Talbot Mills,
Faulkner Street, North Billerica, Massachusetts.

Tax Liability for Taxable Year Ended September 30, 1940.

	Liability	Assessed	Deficiency
Income tax	$37,291.06	$29,702.37	$7,588.69
Declared value excess-profits tax	2,196.12	none	2,196.12
Total	$39,487.18	$29,702.37	$9,784.81

In making this determination of your income tax and declared value excess-profits tax liability, careful consideration has been given to the report of examination dated November 4, 1941; to your protest dated February 19, 1942; to the statements made at the conferences held on August 15, 1942 and December 1, 1942.

If you do not acquiesce in all of the adjustments making up the deficiency indicated, but desire to stop the accumulation of interest on that part of the deficiency resulting from adjustments to which you agree, please fill out the enclosed form of waiver, inserting therein the amount of the deficiency you desire to have assessed at once. The execution of the form for the agreed portion of the deficiency will not deprive you of your right to petition The Tax Court of the United States for a redetermination of the deficiency.

A copy of this letter and statement has been mailed to your representative, Mr. Melville F. Weston, 30 Federal Street, Boston, Massachusetts, in accordance with the authority contained in the power of attorney executed by you and on file with this office.

Adjustments to Net Income
Year ended September 30, 1940

Net income as disclosed by return		$156,328.27
Unallowable deductions and additional income:		
(a) Excessive depreciation disallowed	$2,229.13	
(b) Replacements	767.93	
(c) Interest accrued	3,042.91	
(d) Interest on stockholders notes	40,000.00	46,039.97
Total		$202,368.24
Nontaxable income and additional deductions:		
(e) Adjustment of capital stock tax	$2,882.10	
(g) Adjustment of Massachusetts excise tax	1,021.29	3,903.39
Net income adjusted		$198,464.85
(d) Interest on stockholders notes		$40,000.00

The amount of $40,000.00 deducted as "interest" on line 20, page 1 of your 1940 income and excess-profits tax return has been disallowed for the reason that it does not represent interest within the meaning of Section 23(b) of the Internal Revenue Code, and is not deductible under that section or any other section of the Code.

(EXCERPTS FROM) OFFICIAL REPORT OF PROCEEDINGS BEFORE THE TAX COURT OF THE UNITED STATES

[Filed October 4, 1943.]

[Title omitted.]

Hearing at Boston, Mass. September 21, 1943.

District Court room, Federal Building, Boston, Massachusetts,

September 21, 1943, 3:00 o'clock P.M.

(Met pursuant to notice.)

Before: Honorable C. R. ARUNDELL, Judge.

Appearances:

MELVILLE F. WESTON, Esq., Appearing for Talbot Mills, the Petitioner, 30 Federal Street, Boston, Mass.

M. L. SEARS, Esq., Appearing for the Commissioner of Internal Revenue, the Respondent, 49 Federal Street, Boston, Mass.

PROCEEDINGS.

The Clerk: Docket No. 1066, Talbot Mills.

Mr. Weston: Ready for the petitioner.

Mr. Sears: Ready for the respondent.

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Mr. Weston: I will offer the stipulation; a signed original and a conformed copy which has all the exhibits, letters, annexed; that is, the exhibits presented in duplicate.

* * * * * *

The Court: The stipulation will be received.

Mr. Weston: I imagine, this is a matter so simple that no misunderstanding could arise. But, I would like to ask Mr. Sears to stipulate orally that on pages 9 and 10 [printed page 15], the parentheses which are used to surround certain figures are the equivalent of red ink. In other words, they signify losses.

Mr. Sears: It is so stipulated.

* * * * * *

Mr. Weston: I would like to refer for a moment, Mr. Sears, to the question of any objections to the contents of the stipulation on the score of materiality but, first, I will put in to complete the stipulation the exhibits which it mentions which come in as—this is Exhibit 1-A which is the corporation income and excess profits tax return for Talbot Mills for the fiscal year beginning October 1, 1939 and ended September 30, 1940. The stipulation refers to this and says it will be Exhibit 1-A.

The Court: It will be received.

Mr. Weston: I have also a carbon copy of the deficiency no-

tice; namely, a Treasury letter to Talbot Mills dated January 7, 1943 and this the stipulation says is to be Exhibit 2-B.

The Court: It will be received.

* * * * * *

THOMAS TALBOT CLARK a witness called on behalf of the petitioner, having first been duly sworn, testified as follows:

The Clerk: State your full name and address.

The Witness: Thomas Talbot Clark, 216 Nesmith Street, Lowell, Massachusetts.

Direct Examination by Mr. WESTON.

Q. 1. You are Mr. Thomas Talbot Clark? *A.* Yes.

Q. 2. And you hold what office in the Talbot Mills? *A.* President and treasurer.

Q. 3. And did you hold that office in the year 1939? *A.* Yes, both offices.

Q. 4. And continuously since that time? *A.* Yes.

Q. 5. Are you familiar with the transfers which have occurred in stock and registered notes in the Talbot Mills since 1939? *A.* I have a record of them; not a mental record.

Q. 6. Calling your attention to the fact that at the original exchange of notes for a portion of the stock ratio of one share of stock to each four $100 notes was created so that each of the investors in the corporation held at that time stock and notes in that ratio, Have sales or transfers since occurred, to your knowledge, which have altered the ratio in the case of any investors? *A.* Yes, there has.

Q. 7. Do you have in mind any of these transfers? *A.* I have a record of them if I am allowed to use it.

Q. 8. You may refresh your recollection from anything you have.

* * * * * *

A. On January 18, 1940 there were transferred from the estate of J. T. Taylor four shares of stock to each of three individuals

and 4,800 in notes to a fourth individual and the same—no, on May 28, 1940 there was transferred one share of stock by Sidney Ewart to Talbot Ewart.

Q. 9. And at that time no note was transferred from Sidney Ewart at all? *A.* No. On June 1, 1940 Elizabeth H. Eaton transferred two thousand in notes to F. W. Eaton.

Q. 10. And transferred no stocks? *A.* And no stock.

Q. 11. What is the relationship of F. W. Eaton to Elizabeth H. Eaton? *A.* Brother and sister-in-law.

Q. 12. Brother and sister-in-law; that is, he is the brother of Mrs. Eaton's husband? *A.* He was.

Q. 13. Was? *A.* Yes, I think that is all the transactions.

Q. 14. Of that character? *A.* I think so.

Q. 15. The stipulation contains this statement. "The stock was held on September 30, 1939 by fifteen stockholders who with the exception of one holder of ten shares to qualify as a director were all members of the Talbot family by descent or marriage or were trusts created by such members." Will you state the relationship by blood or marriage which existed between the members of the Talbot family? *A.* What date?

Q. 16. September 30, 1939. *A.* Well, I would have to have a list of the stockholders on that date.

Q. 17. It might be, Mr. Clark, that you would find it easier to state in what generation of the family all those holdings commenced and how the line was branched. *A.* Well, I might say that all of the stockholders were descendants from three brothers or were married to a descendant of the three brothers. Two of those brothers founded the business and a third one had no connection with the business. Well, this is Thomas T. Clark, myself, and I am the second generation from what we may call brother No. 1.

Q. 18. That is, you are a grandson of one of these three brothers? *A.* That's right.

Q. 19. Yes. *A.* Frederick S. Clark, Jr. is the same and is my brother. Lincoln Clark—the same—my brother. Mrs. Elizabeth

H. Eaton—same—my sister. John M. Eaton was Mrs. Eaton's husband. Mrs. Glass Talbot Randell is the same generation and the first cousin.

Q. 20. That is, she is a grandchild of brother No. 2? *A.* No, she is a grandchild of brother No. 1.

Q. 21. But— *A.* Through a different child of No. 1. Darley Randell is her husband. M. A. Taylor trustee for Gertrude T. Taylor, and I presume you want to know about Gertrude?

Q. 22. Yes. *A.* Gertrude Taylor was the granddaughter of brother No. 2 and second cousin of mine. M. A. Taylor was her husband. Mrs. Sidney S. H. Ewart is the wife of another grandson of brother No. 2. Mrs. Harriet T. Parker is a granddaughter of grandfather, brother No. 2. J. Colby Bassett was no relation. Moses G. Parker trust—I don't know what I can say about that.

Q. 23. Well, is that— *A.* (Interposing). To my knowledge—

Q. 24. Well, does that bear approximately the same relationship to the picture as Mrs. Harriet T. Parker? *A.* I presume so. I would say so.

Q. 25. The trust being one of which she is a beneficiary? *A.* Yes, I think so; yes. Mrs. Elizabeth T. Towne is a granddaughter of brother No. 3; unconnected with the business.

Q. 26. Is that the whole list? *A.* Yes, sir.

Q. 27. Is it then fair to say that these members of the Talbot family who are described in the stipulation fall into three groups and each one of these groups is related to each of the other groups as remotely as this, namely, that the grandfather, the grandparent of each one of the three groups was a brother of the grandparent of each other one of the three groups? *A.* That's right.

Q. 28. And no nearer relationship than that between the three groups existed in 1939? *A.* Right.

Q. 29. Where—will you then read—oh, no, this isn't summarized, is it?

Mr. Sears: If I may see this, Mr. Weston, I may be willing that it go in. *A.* They all had a common great grandfather.

Q. 30. Yes, they all had a common great grandfather.

Mr. Sears: Is it as to the application of columns 1, 2 and 3?

Mr. Weston: These are names, addresses and number of shares

Mr. Sears: I have no objection to that going in. It will sav time.

The Court: Yes.

Mr. Sears: You will give me a copy of that, won't you, Mr Weston?

Mr. Weston: Would it not be best if I simply had one of thes made up having this taken for the moment and then having th privilege of substituting a properly prepared one?

The Court: Very well. But, let's get it in and get it marke and you can withdraw it and make a transcript.

The Clerk: Petitioner's Exhibit No. 3.

[Document referred to, received in evidence and marke Petitioner's Exhibit No. 3, of this date.]

Q. 31 (by Mr. Weston). In the stipulation, Mr. Clark, at pag 11, a list of notes is shown. This is paragraph 17. I show yo this list and ask you whether all of these notes were outstandin at one time or whether some were renewals of other notes? *A* They were not all outstanding at one time.

Q. 32. Were many of them renewals? *A.* Many of them wer renewals of other notes.

Q. 33. Can you tell which are the original notes and whic are the renewals? Just a minute.

Mr. Weston: I will save you the trouble of answering tha question, because Mr. Sears is agreeable that I may read into th record the story with respect to these notes.

In the notes payable to the New England Trust Co. which ap pear here were five entries of $50,000 each. There is actually bu a single $50,000 note. Starting with the note dated 7/20/39, th other four entries are renewals of the same note.

In the list of notes payable to the First National Bank of Bosto there are actually two notes and the renewals of those two notes One is the note originally dated 7/12/39 for $35,000 which wa

renewed on January 30, 1940 and again on July 13, 1940 and on the last occasion was increased to $40,000.

The second is a note for $50,000 originally dated October 28, 1939 and renewed on January 18, 1940, April 26, 1940 and July 18, 1940, each time in the same amount of $50,000.

Q. 34. I will ask you, Mr. Clark, whether the $35,000 note to the First National Bank of Boston originally dated July 12, 1939 was secured by a pledge of life insurance in the same manner as the stipulation indicates the renewals of that same note was secured? *A.* Yes, it was.

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Q. 35. Mr. Clark, in one of the directors' meetings of which the Government has asked to have minutes annexed to the stipulation; namely, the meeting of November 27, 1940, this statement appears; "The treasurer reported the ability to pay all bank loans and the arrangement to borrow $400,000 at three per cent." Will you explain what that entry meant? *A.* That meant that we had enough cash and accounts receivables which we could cash at the date of the statement to pay the $100,000, I believe, that was due the banks. At the same time our selling agents Parker, Wilder & Co. were carrying our entire raw material inventory which off-hand I would say was up in the three hundred thousand dollars—but, I am not positive. And they were charging us six per cent for the privilege of carrying it and the purpose of borrowing $400,000 instead of $100,000—it was really an increase—we never paid the $100,000. We raised it from $100,000 to $400,000. The purpose of that was to take over the inventory from Parker, Wilder & Co., borrowing the money at three per cent instead of paying Parker, Wilder six per cent.

Q. 36. Who did you borrow this $400,000 from? *A.* The same banks who had the $100,000.

Q. 37. So, actually although you were able to pay off the $100,000 you owed to banks you were not able at that time to pay off the much larger Parker, Wilder & Co. indebtedness? *A.* That's right.

Q. 38. Unless you borrowed that money? *A.* That's right.

Q. 39. And actually what you did and what this entry referred to was to increase the bank loans to $400,000 and in the process pay off Parker, Wilder & Co.? *A.* That's right.

Q. 40. Is that correct? *A.* That's right.

Q. 41. What was the condition of the Talbot Mills in the years 1937 to 1938; very broadly speaking? *A.* In the financial condition?

Q. 42. Yes. The whole picture of the company. How would you describe it? *A.* Well, in the fall of 1937 it became very apparent that it was anything but competitive and we had lost so much of our liquid resources as we could afford to lose and still stay in business. If we continued losing money at the rate we were losing it at that time. It was very critical and it was a case of doing something radical or liquidate.

Q. 43. Did you present to your stockholders the question whether you should or should not liquidate? *A.* Yes, sir.

Q. 44. What was their decision? *A.* Their decision was to continue in business.

Q. 45. In connection with that decision did you make any statements to your stockholders with respect to what you proposed to do if they would leave you in business? *A.* Plenty.

Q. 46. And broadly speaking, what did you propose to do? *A.* We proposed to run the mill out and discharge everybody on the payroll except the watchman, the fireman and the treasurer. It was then decided to completely rehabilitate the physical plant and to reorganize the personnel; not so much the day workers as the supervisory force, the executive force. It was also suggested that we might improve our situation in regard to state taxes and local taxes. That was done. It was also suggested that we might improve the capital structure of the corporation in the way to make it more attractive to the investors. All of those things were eventually done.

Q. 47. Were those matters discussed at length with your stockholders and directors by the officers? *A.* They were.

Q. 48. And were they then taken and carried through on all fronts to a conclusion? *A.* Oh, I wouldn't say that the conclusion had yet been reached.

Q. 49. But a course of action was embarked on which has lasted to the present time? *A.* That's correct.

Q. 50. And did that course of action include changes in the capital structure, voted at the time of this exchange of notes to stock? *A.* It did; not in detail.

Q. 51. What? *A.* Not in detail.

Q. 52. No, not in detail.

Mr. Weston: Your witness.

Cross Examination by Mr. SEARS.

X-Q. 53. Mr. Clark, in May of 1939 a directors' meeting was held at which it was determined to improve the capital structure with an eye to improving the condition of the company. In what regard do you feel that you improved the condition of the company by the calling in of the stock and the issuance of the notes? *A.* Well, we have lessened equity which enables a concentration of control to effect a stable management.

X-Q. 54. You didn't receive any new capital though, did you? *A.* No, not at that time.

X-Q. 55. There was nothing paid in for these notes, except the turning in of the stock and the reissuance of the notes? *A.* That's all.

X-Q. 56. The instructions were given at the directors' meeting of May 8 to investigate the situation and on September 14, 1939 the so-called plan of reorganization was submitted to the directors, is that correct? *A.* I believe so.

X-Q. 57. Were there any meetings held between those dates? *A.* Not unless they are recorded.

Mr. Sears: Well, I didn't ask you to bring the minute book in, but, are you sure, Mr. Weston, that that is the fact? Do you know whether that's true?

Mr. Weston: No, I don't know whether it was true.

X-Q. 58. You did pay off some machinery notes during the fiscal year ending 1940, did you not? A. If it's in the stipulation, we did. I can't recall.

X-Q. 59. You don't recall paying off $100,000? A. I recall paying it off but not the date.

X-Q. 60. You don't recall the date?

Mr. Sears: I think, that's all I have.

Redirect Examination by Mr. WESTON.

Q. 61. In response to counsel's question, about how the capital structure of the company was improved, you mentioned the fact that reducing of the equity would make it possible for a smaller amount of capital acquiring stock from time to time to bring the control together so that a stable management might be insured. I suppose you had in mind that your family situation might some day call for more concentration in one of the branches? A. Yes, sir.

Q. 62. Than then existed? A. Yes.

Q. 63. Do any other advantages occur to you as having been achieved by the exchange? A. Yes. It enabled the investors to receive certificates of interest or whatever you call it in a form which would be negotiable and enable them to get their money out of the business if they so desire.

Q. 64. That, is— A. (Interposing): Particularly a minority stockholder or a bondholder or whatever it may be who could not otherwise compel liquidation.

Q. 65. That is, a man who as a stockholder and a minority stockholder could never get his money out without the others joining with him? A. That's right.

Q. 66. Now, has a note with a definite maturity and a notice that he can call for his money some day? A. Well, not only that but it's negotiable. He may not have to wait 25 years.

Q. 67. Meanwhile he can sell it? A. It's a sort of investment which has a more or less definite value whereas the stock had a very indefinite value.

Q. 68. In your opinion as a treasurer of your company of your

knowledge of the corporation, are one of these notes a better investment for a man to buy than the stock? *A.* Yes, sir.

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Q. 69. You have mentioned, Mr. Clark, two advantages in the corporate structure that you deemed to have derived from this exchange. One is the reduction of the equity capital so as to render control of the corporation and the stable management more easily obtainable, and the second is to give the investor a security that after at least a certain known length of time, he can cash in if he wants to and which in the meantime he will find in your opinion more saleable than the common stock. Those are two reasons why you think the capital structure was approved; are there any others? *A.* Well, in order to persuade the stockholders that the company should be kept running and not liquidated, it was necessary to offer this among other things—this change in capitalization with its advantages which have been mentioned, among other things, to get their approval of continuing the business.

Q. 70. Was there any advantage from the point—

Examination by the Court:

Q. 71. Now, I don't quite understand that. You get a small group of stockholders. Now, if they weren't operating the business they can say so. If they don't want to they can do it themselves. Well, what do you mean? Do you mean that you can say to the stockholders that we will give you a thousand or so if you will continue? *A.* Well, sir, the stockholders for a while did not want to continue the business and they had to have some bait; they had to have some chance of getting—either getting the money out or getting something that they could sell in order to get their money out.

Q. 72. Well, who gives them the bait? *A.* Well, they give it to themselves. But, somebody had to suggest it to them. They had no ideas of their own and the program had to be presented to the stockholders which had sufficient appeal to entice them into a vote to continue the business.

Q. 73 (by Mr. Weston). And who presented that program? *A.* I presented that program to the directors, and the directors to

the stockholders, and there was sufficient argument about it so that one director resigned because he was not in sympathy with the program. The stock was not sufficient to hold up the program.

Q. 74 (by the Court). Well, the stockholders at the time did not get any advantage in the sense of getting any money out of the business? *A.* No, not at the moment. But, they got a security which was negotiable. Stock in a small closely held corporation —there is no market for them whatever.

Q. 75. Well, why were the notes drawn in this manner? If you want to get negotiability for your stockholders why didn't you give it a negotiable note?

Mr. Weston: If I may interject, sir, isn't that begging the question? When you read the terms of the notes you will find that had a negotiable note. It's registered. It does not in the least impair their general transferability.

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Q. 76. Is it also true, Mr. Clark, that the question or that the fact that interest on these notes would be deductible for Federal tax purposes was taken into account? *A.* It was.

Q. 77. And were the several advantages including that last one that you have mentioned—were they presented to the stockholders and the directors for consideration? *A.* They were.

Q. 78. By whom were they presented? *A.* By myself.

Q. 79. And—on what occasions were they presented? *A.* They were presented to the directors in the fall of 1939—'37.

Q. 80. And were there discussions thereafter? *A.* And to the stockholders following the directors.

Q. 81. And were there discussions then in the years between the commencement of the desired change in 1937 and this final meeting in 1939—were there talks during all that time about what we will do with the company to improve it? *A.* Yes, sir.

Q. 82. And so far as one man can know what goes on in the minds of another, were these the inducements that led the directors and stockholders to act as they did? *A.* You mean everything that I have mentioned?

Q. 83. Yes. *A.* The rehabilitation and the everything all together combination?

Q. 84. And particularly the capital exchange? *A.* Yes, they were.

Q. 85. So far as you know, so far as one man can know about what is in the mind of another, these advantages of all the changes were the inducements to the directors and stockholders to make them—is that correct? *A.* To make the exchange?

Q. 86. To make the exchange. *A.* Yes.

* * * * * *

Recross Examination by Mr. Sears.

X-Q. 87. You mentioned the fact that this recapitalization was considered in 1937? *A.* Not in detail.

X-Q. 88. Not with regard to the exchange in stock and notes? That was discussed in 1939? *A.* But the details were worked out in 1939.

X-Q. 89. You said the details. Had you any discussion as to a change of capital structure in 1937? *A.* Not in detail.

X-Q. 90. What do you mean by detail? *A.* We didn't suggest swapping one for four.

X-Q. 91. You suggested? *A.* No, we didn't.

X-Q. 92. That was a new item in 1939? *A.* Well, it was suggested that some swap might be made but no details were worked out in 1937.

X-Q. 93. What swap could be made? *A.* That we could change our capital structure.

X-Q. 94. To get an interest deduction? *A.* Well, not alone, to get marketability and control.

X-Q. 95. And to guarantee the income to the stockholders? *A.* No guarantee on notes is more than two per cent.

X-Q. 96. Well, to the extent of two per cent then as they would be guaranteed in income whereas a dividend would have to be declared? *A.* No. At that time there was no two per cent and ten per cent was not worked out.

X-Q. 97. But in 1939 it was worked out? *A.* In 1939 it was worked out?

X-Q. 98. And one of the advantages was that the stockholders would obtain a regularity of income? *A.* Yes.

Mr. Weston: I object to the use of the word "stockholders" in just that form. You are obviously asking what the noteholders were to obtain.

Mr. Sears: I am talking about the stockholders. The stockholders are going to receive the notes and the guaranteed income on them, whereas their stock would have not unless declared by the directors. *A.* Well, not in 1937.

X-Q. 99. I am talking about 1939. *A.* 1939? Well, 1939 when the details were all worked out.

X-Q. 100. That's one of the advantages that you offered to the stockholders, is it not true? *A.* That they would get two per cent.

X-Q. 101. As a matter of fact, you know the terms of the note. They didn't even have to get the two per cent, did they? The board of directors could waive that interest. *A.* I don't think so. The two per cent is mandatory.

X-Q. 102. If earned. *A.* No.

X-Q. 103. No? *A.* I think the two per cent is mandatory.

X-Q. 104. But it could be determined not later than 1964?

Mr. Weston: Well, we will leave that for the stipulation.

Mr. Sears: That's all.

Redirect Examination by Mr. WESTON.

Q. 105. You believe it, Mr. Clark, that it is a fact that the recapitalization or that there should be some sort of recapitalization, was mentioned and talked of in 1937? *A.* Right.

Mr. Weston: That's all.

Mr. Sears: The respondent rests.

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3 T. C. No. 11

THE TAX COURT OF THE UNITED STATES.

Talbot Mills, Petitioner,

v.

Commissioner of Internal Revenue, Respondent.

Docket No. 1066. Promulgated January 21, 1944.

Petitioner, a family corporation, in 1939 issued, in exchange for four-fifths of its outstanding capital stock, "registered notes" in face value equal to the par value of the stock surrendered, having a maturity date, and bearing interest at a variable rate from 2 to 10 percent computed with reference to profits. The interest was deferrable in the discretion of the directors, and interest and principal were subject to subordination to outside creditors. *Held*, the security is more in the nature of a capital investment than a loan to the corporation, and payments made as interest are in fact dividends, not deductible from gross income under section 23(b) of the Internal Revenue Code.

MELVILLE F. WESTON, Esq., for the Petitioner.

M. L. SEARS, Esq., for the Respondent.

The Commissioner determined deficiencies of $7,588.69 in corporation income tax and $2,196.12 in declared value excess profits tax for the fiscal year ending September 30, 1940. Certain minor concessions have altered the amounts in controversy to $6,940.15 and $2,415.73, respectively. These deficiencies resulted from a disallowance by the Commissioner of a claimed deduction of $40,000 for interest paid by the petitioner on certain securities issued in exchange for part of its stock. The sole question is whether this amount was properly deductible as interest within the meaning of section 23(b) of the Internal Revenue Code.

FINDINGS OF FACT.

The essential facts, most of which are stipulated and are hereby found accordingly, are as follows:

The petitioner, a Massachusetts corporation with principal offices in North Billerica, filed its return for the fiscal year in question with the collector for the district of Massachusetts. Prior to the transactions out of which arose the present controversy the petitioner had outstanding as its total capital stock 5,000 shares of common stock, par value $100. This stock was held on September 30, 1939 by 15 stockholders who, with the exception of one holder of ten qualifying shares, were all members of the Talbot family by descent or marriage, or were trusts created by such members.

For several years the company had been gradually losing money and in 1937 there was some discussion among the stockholders as to liquidation. However, upon the basis of a proposed renovation of plant and personnel, plus a possible recapitalization, they decided to continue the business. On May 8, 1939, by corporate resolution, the treasurer was authorized "to retain counsel to examine the capital structure of the company with the view to seeing if any modification can be made in same to the advantage of the company." On September 14, 1939, a plan of reorganization was submitted to the directors and adopted by them. The stockholders gave their unanimous approval on September 29, 1939. The tax advantage was one of the motivating facts in the adoption of this plan.

In pursuance of the plan, each holder surrendered 4/5ths of his stock, which was duly retired by the corporation, and the capital stock accordingly reduced. In return for the stock so surrendered the petitioner issued "registered notes", in aggregate face values equal to the aggregate par value of the stock retired. The total amount of the notes issued was thus $400,000.

The notes are voluminous and complex. Maturity is set for December 1, 1964, slightly more than 25 years from the date of

issue. They provide for annual interest payable on December 1 of each year, but payment of interest may be deferred by vote of the board of directors for such time as they "may in good faith determine to be necessary by reason of the condition of the corporation . . . provided that such suspension of payment shall in no wise relieve the corporation of the obligation to pay the amount suspended at some future time and shall in no event operate to defer payment beyond December 1, 1964.".

The rate of interest was provided as follows: "Interest hereon shall be payable annually . . . at a rate which shall not exceed 10 per cent nor be less than 2 per cent and, subject to these limitations, shall be a rate computed as follows:—There shall be taken a sum equal to two-thirds (2/3ds) of the net earnings of the corporation for the fiscal year ended last previous to such December 1, computed in accordance with the regular bookkeeping methods and practices of the corporation as established from time to time in good faith by its directors and officers but without deduction for federal income taxes paid or accrued and without deduction for interest upon these notes, and the rate of interest shall be the rate, figured to the nearest one-quarter (1/4%) which such sum would represent as interest upon an assumed principal sum of Four Hundred Thousand ($400,000) Dollars. Provided, nevertheless, that from and after the close of the fiscal year ended next previous to December 1, 1964, and for such further time as this note shall remain unpaid, interest shall be at the rate of six per cent (6%) per annum, and such interest to December 1, 1964 shall be included in the installment payable at that date."

The notes further provided that no dividends were to be paid on any shares of stock until all then due interest on the notes was satisfied. In the event of bankruptcy, receivership, dissolution, or liquidation, the principal and interest were to become immediately due, with interest at the rate of six per cent from the close of the preceding fiscal year.

No mortgage of the real estate of the corporation or of its machinery or equipment to secure an obligation maturing after

December 1, 1964, other than a purchase money mortgage, could be made while the notes were outstanding without the consent of the holders of 3/5ths in interest of the notes. Power to subordinate to any obligation maturing not later than December 1, 1964 was vested in the directors, such subordination to impose upon the holders no personal liability other than a liability to deliver to the unsatisfied creditors any sums or securities paid to the holder in connection with any reorganization, or in any substitution of the notes. The corporation might at any time pay and retire the notes at par plus accrued interest, except as otherwise provided in any subordination agreement. There then followed this provision:

> . . . With the written consent of the corporation and of the holders of three-fifths (3/5ths) in amount of the total amount of these notes at the time outstanding, filed with the corporation, any of the terms and provisions of this series of notes may be altered or amended so as to bind the corporation and every holder, whether consenting or not, provided that no such change shall:—(a) extend the date for the maturity of the principal of the notes; (b) alter the rate of interest or the method of computing the rate of interest, except in so far as required for an adjustment to a changed fiscal year as above; (c) diminish the principal amount payable at maturity or the amount to be paid upon any earlier payment as above provided; or (d) vacate or diminish the effect of any subordination previously voted and in force.

The notes were transferable by endorsement on an attached form, which was required to be authenticated by the clerk of the corporation. In the following years some few notes totaling $6,800 were transferred, but always within the close family circle.

Shortly after the adoption of this plan, the notes were subordinated, by vote of the board of directors, to three loans. Two banks to which the taxpayer was indebted in the amount of $100,000 required, as a condition of their forbearing to demand payment, the execution of a formal agreement of subordination as to

both principal and interest. On October 10, 1939 the subordination was voted, and on the same date the required agreement was executed. This agreement covered all existing and future indebtedness, and provided that:

> So long as any part of the Bank Indebtedness shall remain unsatisfied, the Noteholders will not, without the prior written consent of each of the Banks, demand, accept or receive from the Mills any payment of principal of or interest on or any collateral or other security for the Notes held by them respectively, or any other notes or obligations in renewal of or in substitution therefor, except, pursuant to the exchange provisions contained in the Notes, another Note of the same tenor, and the Mills will not, without such written consent, pay any amount on account of the principal of or interest on, or give any collateral or other security for, any of the Notes, or give any other Notes or obligations in renewal thereof or in substitution therefor, except as aforesaid, to any Noteholders.
>
> In the event of any petition in bankruptcy being brought by or against the Mills, and in the event of any other proceedings for the liquidation of the Mills, either by its voluntary action or otherwise, the Noteholders will assign and pay over to the Banks, ratably in proportion to the amount of the Bank Indebtedness owed to them respectively, to the extent necessary to satisfy the Bank Indebtedness in full, any and all distributions and payments in respect of the Notes to which the Noteholders would be entitled in any such proceedings.

This agreement further provided that in the event of any reorganization or composition, any payment to the noteholders should be paid over to the banks, to be applied to the indebtedness; and any securities or property so delivered to the banks to be held by them subject to the subordination. No personal liability other than the above was imposed on the noteholders.

On the same date the notes were also subordinated, as to principal and interest, to a $100,000 machinery loan, and to a further

$30,000 indebtedness to one of the banks. All of these subordinations have since been terminated by payment of the obligations.

On November 27, 1940, the petitioner's treasurer reported that:

> . . . he had ascertained and fixed at 10 per cent the rate of interest applicable to the registered notes of this Corporation for and on account of the fiscal year ended September 28, 1940, such rate of 10 per cent being a rate less than that computable with reference to the net earnings of said fiscal year under the terms of said notes and being the maximum rate provided by the terms of said notes.

The report was forthwith accepted and approved. The directors then voted to defer the payment of three-fourths of the interest which would otherwise be payable on December 1, 1940. On March 25, 1941, this deferment was partially terminated, and on September 15, 1941 wholly terminated, so that in three installments over the course of the fiscal year the total of $40,000 was disbursed. It is the deduction of this amount which the respondent contests.

Opinion.

Arundell, Judge: The facts presented raise the narrow question as to whether or not the acts of the taxpayer have been sufficient to give rise to an indebtedness within the ambit of section 23(b) of the Internal Revenue Code. If so, then the payments made as interest are deductible as such; if not, then they must be considered in fact dividends, hence not deductible.

Precedent provides no ready test. The question is factual, and no one factor may be said to be controlling. *Commissioner* v. *Schmoll Fils Associated, Inc.*, 110 Fed. (2d) 611. "The determining factors are usually listed as the name given to the certificates, the presence or absence of maturity date, the source of the payments, the right to enforce the payment of principal and interest, participation in management, status equal to or inferior to that of regular corporate creditors, and intent of the parties." *John Kelley Co.*, 1 T.C. 457.

Numerous cases are cited by petitioner which bear upon, but

do not decide the question. Especially relied upon is *Commissioner* v. *O. P. P. Holding Corp.*, 76 Fed. (2d) 11. In that case a corporation, in part payment of the entire capital stock of another corporation, issued debenture bonds maturing in 25 years, unless extended by a 2/3rds vote of the holders, bearing interest at eight per cent with provisions for the subordination of principal and deferment of interest. The deferment was not, however, to relieve the corporation of the ultimate obligation to pay. The securities were held to evidence an indebtedness, and payments made as interest thereon were properly deductible. But these securities lacked the variable rate of interest computed with reference to profits that is a prominent feature of the present notes; and, further, they were not, as here, issued in exchange for stock of the issuing corporation.

In *John Kelley Co., supra,* there was present the exchange feature. There the petitioner, a closely held corporation, issued maturing, eight per cent "income debenture bonds" in exchange for outstanding preferred stock, the excess after exchanges to be sold at face value to the shareholders. The interest was to be paid "out of income", and there was provision for suit for enforcing payment of principal and interest in case of default. This court held that the transaction gave rise to a valid indebtedness, and the deduction of interest payments was allowed. Here again there are distinctions. In *John Kelley Co., supra,* there was a flat rate of interest, though payable out of income, as contrasted with the variable, profit-determined rate of the Talbot notes; the interest payments were due whenever the net income was sufficient, with provision for suit in case of default in punctual payment, whereas in the instant case the payment of interest might be deferred, though the net income was sufficient, for such time as the directors might see fit; and debentures remaining after the exchange were issued on subscription to the stockholders, whereas this transaction was exclusively an exchange.

In *Kena, Inc.*, 44 B.T.A. 217, a substantially similar interest provision was considered, and this court, holding for the taxpayer,

said: "It is not essential that interest be computed at a stated rate, but only that a sum definitely ascertainable shall be paid for the use of borrowed money, pursuant to the agreement of the lender and the borrower." Nor is the deferability of interest payments at the option of the corporation fatal, standing alone. *Commissioner* v. *O. P. P. Holding Co., supra.*

It is the cumulation of these various restrictive features that tends to cast doubt on the real nature of the instant transaction. In this state of affairs reference must be had to the circumstances surrounding the issuance, to determine the intent of the parties, See *Commissioner* v. *Proctor Shop, Inc.*, 82 Fed. (2d) 792, where it is stated, in the words of the United States Board of Tax Appeals. "In each case it must be determined whether the real transaction was that of an investment in the corporation or a loan to it. . . . The real intention of the parties is to be sought and in order to establish it evidence *aliunde* the contract is admissible."

The factor of tax avoidance loomed large in the minds of the parties by their own admission, and indeed appears to have been the only substantial purpose motivating the transaction. It was stated in testimony that there were also the advantages of a reduction in equity control, enabling a concentration of control to effect a stable management, and the providing of a form of investment which would be negotiable, and more readily saleable. As to the first, it is difficult to see how a pro rata reduction of capital stock would facilitate concentrated control, nor did it in fact change the control. Each shareholder retained the precise voice in the management which he had prior to the transaction. He retained the same right to participate in the profits of the business; what he did not receive by way of interest he would take by way of dividends on his remaining stock. As to negotiability, only a very slight fraction of the notes has actually been severed from stockholdings, and this all within the close family circle. It is questionable how much more saleable than the original stock the restricted, subordinated, deferable notes would have been.

In the light of these facts, it appears that what the parties really

intended to create was a security retaining the profit-sharing advantage of stock, leaving intact their voice in the management, but extending a tax advantage to the corporation not possible in stock. This would seem to create no proper indebtedness. This being so, the 2 per cent minimum provision of the note will stand upon no better footing than the whole.

In view of the foregoing, it is our conclusion that the "registered notes" were more in the nature of a capital investment than a loan to the corporation, and payments made as "interest" are not deductible under section 23(b) of the Internal Revenue Code.

Decision will be entered under Rule 50.

[Title omitted.]

RESPONDENT'S COMPUTATION FOR ENTRY OF DECISION.

[Filed February 9, 1944.]

The attached proposed computation is submitted, on behalf of the respondent, to The Tax Court of the United States in compliance with its opinion determining the issues in this proceeding.

This computation is submitted in accordance with the opinion of the Tax Court, without prejudice to the right of either party to contest the correctness of the decision entered herein by the Tax Court, pursuant to the statute in such cases made and provided.

J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue.

Of Counsel:

CHARLES P. REILLY,
Division Counsel, Bureau of Internal Revenue.

Petitioner is in agreement with respondent's computation.

MELVILLE F. WESTON,
Counsel for Petitioner.

hd 2-3-44

C-TS:NED GB:*Re* computation

February 3, 1944.

AUDIT STATEMENT

In re: Talbot Mills, Faulkner Street, North Billerica, Mass.

Docket No. 1066

Fiscal year ended September 30, 1940

Declared Value Excess Profits Tax

Liability	Assessed	Deficiency in Assessment
$2,415.73	None	$2,415.73
Liability	**Paid**	**Deficiency in Payment**
$2,415.73	None	$2,415.73

Income Tax

Liability	Assessed	Deficiency in Assessment
$37,249.33	$30,309.18	$6,940.15
Liability	**Paid**	**Deficiency in Payment**
$37,249.33	$30,309.18	$6,940.15

Computation of tax liability in accordance with the opinion of the Tax Court of the United States entered January 25, 1944.

Talbot Mills Fiscal Year ended September 30, 1940.

Schedule 1 Net Income

Net income deficiency notice dated January 7, 1943	$198,464.85
Adjustment	None
Net income adjusted	$198,464.85

The stipulation of facts filed with the Tax Court of the United States on page 3, paragraph IV indicates that all adjustments to net income made in the deficiency notice were accepted by the petitioner with the exception of the disallowance of the deduction of $40,000.00 as "interest" on "certain notes".

The opinion of the Tax Court sustains the disallowance of the item protested and recommends no change in the net income computed in the deficiency notice.

Schedule 2 Computation of Tax

Declared Value Excess-Profits Tax

Taxable net income, Schedule 1			$198,464.85
Less: Dividends received credit		None	
Value of capital stock as declared in capital stock tax return for year ended 6/30/40	$1,591,655.98		
Adjustment to net income for fiscal year ended 9/30/39 (Revenue agent's report dated March 25, 1941.)	26,971.96		
Adjusted value of capital stock	$1,618,627.94		
10% of $1,618,627.94		$161,862.79	$161,862.79
Net income subject to declared value excess-profits tax			$36,602.06
Amount taxable at 6%			36,602.06
Excess-profits tax at 6% (as shown in deficiency notice)			2,196.12
Defense tax, 10% of $2,196.12 (erroneously omitted in deficiency notice)			219.61
Total declared value excess-profits and declared value excess-profits defense tax			$2,415.73
Declared value excess-profits and declared value excess-profits defense tax assessed December, 1940, Account $400,030			None
Deficiency in assessment of declared value excess-profits tax and defense tax (page 3, Stipulation of Facts)			$2,415.73
Declared value excess-profits and defense tax liability			$2,415.73

Declared value excess-profits and defense tax paid	None
Deficiency in payment of declared value excess-profits and defense tax	$2,415.73
Income Tax	
Net income, schedule 1	$198,464.85
Less:	
Declared value excess-profits and excess-profits defense taxes	2,415.73
Adjusted net income	$196,049.12
Income tax under General Rule	
19% of $196,049.12	$37,249.33
Income tax assessed December 1940, Supplemental Account No. 400030	29,702.37
Deficiency in assessment (Page 3, Stipulation of Facts)	$7,546.96
Additional assessed July 1943, Account No. 529002	606.81
Deficiency to be assessed (Amount in controversy)	$6,940.15
Income tax liability	$37,249.33
Income tax paid:	
December 17, 1940 $7,425.60	
April 5, 1941 7,425.60	
June 20, 1941 7,425.60	
September 17, 1941 7,425.57	
July 24, 1943 606.81	$30,309.18
Deficiency in payment	$6,940.15

C-TS:NED GB

STATEMENT OF ACCOUNT

In re: Talbot Mills, Faulkner Street, North Billerica, Mass.

Docket No. 1066

Fiscal Year ended September 30, 1940

Declared Value Excess Profits and Defense Tax Liability	$2,415.73

Assessed December 1940, Supplemental Account No. 400030			None
Deficiency in assessment			$2,415.73
Liability			$2,415.73
Paid			None
Deficiency in payment			$2,415.73
Income Tax			
Liability			$37,249.33
Assessed December 1940, Supplemental Account No. 400030		$29,702.37	
Assessed July 1943 Account No. 529002		606.81	30,309.18
Deficiency in assessment			$6,940.15
Liability			$37,249.33
Paid:	December 17, 1940	$7,425.60	
	April 5, 1941	7,425.60	
	June 20, 1941	7,425.60	
	September 17, 1941	7,425.57	
	July 24, 1943	606.81	30,309.18
Deficiency in payment			$6,940.15

GB/mgw

[Title omitted.]

DECISION.

Entered February 12, 1944.

Pursuant to the findings of fact and opinion promulgated January 21, 1944, the respondent herein having on February 9, 1944, filed a recomputation and the petitioner having agreed thereto, now therefore, it is

Ordered and decided: That there are deficiencies in declared value excess profits tax and income tax for the fiscal year ended September 30, 1940 in the respective amounts of $2,415.73 and $6,940.15.

Enter: C. R. ARUNDELL, *Judge.*

[Title omitted.]

PETITION FOR REVIEW.

[Filed May 2, 1944.]

The above-named Talbot Mills hereby petitions for review, by the United States Circuit Court of Appeals for the First Circuit, of the decision of the Tax Court of the United States rendered upon its petition in the cause numbered in the docket of said Tax Court of the United States as above; and in support of this its said petition for review avers as follows:

1. The controversy in the above-entitled cause relates to the federal income and declared value excess profits taxes of the petitioner for its fiscal year ended September 30, 1940. The petitioner claims to be entitled to deduct, in computing its taxable income for such fiscal year, certain sums accrued during that year as interest upon its outstanding registered notes. The Commissioner of Internal Revenue has denied such deduction and has asserted, and said Tax Court of the United States has now by its decision rendered February 12, 1944 affirmed, deficiencies for the said year as follows: Declared value excess profits tax $2,415.73, income tax $6,940.15; which decision your petitioner asserts to be erroneous.

2. The petitioner is Talbot Mills, a Massachusetts corporation with a principal office at Faulkner Street, North Billerica, Massachusetts. It is the only taxpayer involved in the above-entitled cause and is the sole petitioner for review herein.

3. The petitioner's income and declared value excess profits tax return for its said fiscal year ended September 30, 1940 was duly filed in the office of collector of internal revenue for the District of Massachusetts at Boston, Massachusetts, and said decision of the Tax Court of the United States is therefor reviewable by the United States Circuit Court of Appeals for the First Circuit.

Wherefore the petitioner prays that the said decision of the Tax Court of the United States may be reviewed by the said

United States Circuit Court of Appeals for the First Circuit and be reversed and the said deficiencies disallowed.

TALBOT MILLS,
by MELVILLE F. WESTON,
its Attorney of Record.

[Title omitted.]

NOTICE OF FILING PETITION FOR REVIEW.

[Filed May 3, 1944.]

To J. P. WENCHEL, *Chief Counsel, Bureau of Internal Revenue:*

You are hereby notified that Talbot Mills did, on the second day of May, 1944, file with the clerk of The Tax Court of the United States, at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the First Circuit, of the decision of this court heretofore rendered in the above-entitled case. Copy of the petition for review as filed is hereto attached and served upon you.

Dated this third day of May, 1944.

B. D. GAMBLE, *Clerk,*
The Tax Court of the United States.

Service of copy of petition for review acknowledged this May 4, 1944.

J. P. WENCHEL, SLY,
Chief Counsel, Bureau of Internal Revenue,
Attorney for Respondent.

[Title omitted.]

PETITIONER'S DESIGNATION WITH RESPECT TO CONTENTS OF RECORD UPON PETITION FOR REVIEW.

[Filed May 2, 1944.]

Now comes the petitioner in the above-entitled cause, now petitioner for review herein, and hereby designates as the portions of the record, proceedings, and evidence to be included in the record upon review of the above-entitled cause the following:

1. The petitioner's petition for redetermination of the deficiencies, on file herein; omitting, however, the exhibits annexed to said petition, namely, Exhibit A (the deficiency letter) inasmuch as the same subsequently appears in evidence as Exhibit 2-B, Exhibit A-1 (report of Revenue Agent) since the same was excluded from the evidence upon the trial of the cause, and Exhibit B (the form of registered note) since the same subsequently appears in evidence as Exhibit 4-D.

2. The amended answer of the Commissioner of Internal Revenue, on file herein; omitting, however, the revised audit statement thereto annexed, since all matters relating to the amount in controversy are subsequently disposed of by the stipulation of facts and the agreed recomputation.

3. The stipulation of facts on file herein, together with the exhibits thereto annexed; omitting, however, the portions, enumerated in Schedule A hereto attached, of certain of said exhibits, not material to the determination of the cause and in no wise adverted to by the Tax Court in its findings of fact and opinion.

4. The following portions of Exhibit 1-A (the return, incorporated by reference in, but not annexed to, the stipulation of facts), namely: the Adjusted Net Income Computation and Total Income and Excess-Profits Taxes, as shown on page 1 of the return, *i.e.*, those items on that page numbered 1 through 37, with headings; Schedule A—Excess-Profits Tax Computation—on page 2 of the

return, *i.e.*, lines numbered 1 through 8 on that page; Schedule B —Income Tax Computation—on page 2 of return, so far as relevant, *i.e.*, lines numbered 16 through 20, with headings, and line numbered 54; that portion of Schedule O—Balance Sheets—on page 5 of the return, which deals with liabilities, *i.e.*, lines numbered 9 through 17 of Schedule O, with headings.

5. Exhibit 2-B (the deficiency letter, incorporated by reference in, but not annexed to, the stipulation of facts) omitting therefrom those portions thereof, found under the heading "Explanation of Adjustments" which deal with (a) excessive depreciation disallowed, (b) cost of replacing roof on repair shop, (c) interest accrued, (e) adjustment of capital stock tax (f) adjustment of Massachusetts excise tax.

6. The transcript of testimony herein as stenographically reported; omitting, however, the opening statements and colloquies, constituting no part of the evidence, enumerated in Schedule B hereto attached.

7. The findings of fact and opinion of the Tax Court promulgated January 21, 1944.

8. The recomputation of deficiencies, filed herein.

9 The decision rendered and entered February 12, 1944.

10. Appropriate indications of each mission directed herein.

11. This designation; omitting, however, Schedules A and B hereto attached.

MELVILLE F. WESTON,
Counsel for Petitioner.

[Title omitted.]

PETITIONER'S AMENDMENT TO DESIGNATION.

[Filed May 17, 1944.]

Now comes the petitioner in the above-entitled cause, now petitioner for review herein, and hereby amends its designation, hereinbefore filed, and designates, to be included in the record upon

review in the above-entitled cause, the following further portions of the record, proceedings and evidence:

1. The docket entries of the Tax Court.

2. The petition for review, of the decision of the Tax Court, by the United States Circuit Court of Appeals for the First Circuit.

3. This amendment to designation.

MELVILLE F. WESTON,
Counsel for Petitioner.

[Title omitted.]

CERTIFICATE.

I, B. D. Gamble, clerk of The Tax Court of the United States do hereby certify that the foregoing typewritten pages, 1 to 139 [printed pages 1 to 90], inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the praecipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of The Tax Court of the United States, at Washington, in the District of Columbia, this fifteenth day of June, 1944.

B. D. GAMBLE,
[SEAL] *Clerk, The Tax Court of the United States.*

[MEMORANDUM. An order of enlargement of time for docketing case to, and including, July 31, 1944, is here omitted. A. I. CHARRON, *Clerk.*]

PETITIONER'S STATEMENT OF POINTS TO BE RELIED UPON.

[Filed in Circuit Court of Appeals June 27, 1944.]

Pursuant to the requirements of Paragraph 7 of Rule 22 of this court, the petitioner states the points to be relied upon, upon review of the above-entitled cause in this court, as follows:

I. I.R.C. § 23 (b) expressly makes all interest on indebtedness deductible—not just some interest or interest on just some types of indebtedness.

The Tax Court erred in applying in effect a rule that under certain circumstances—nowhere referred to in the statute—interest on indebtedness is not deductible.

II. The words "indebtedness" and "interest" were used in the statute in their common and ordinary meaning, as well established in general law.

The Tax Court erred in applying to the petitioner's registered notes criteria at variance with the above principle, including the application of an untenable distinction between "loans" and "capital investments".

III. The petitioner's registered notes were evidences of indebtedness, within such common and ordinary meaning, and the annual sums accrued thereon, as the consideration for the principal not being paid until maturity, were interest and deductible as such.

The Tax Court erred in construing petitioner's registered notes as not constituting evidences of indebtedness.

The Tax Court erred in holding the annual sum accrued upon petitioner's registered notes not to be interest.

The Tax Court erred in using extrinsic evidence to control the meaning of an unambiguous written instrument.

The Tax Court erred in holding that the annual sum accrued as interest upon petitioner's registered notes was not deductible as such.

IV. To hold otherwise, merely upon the basis of certain facts found by the Tax Court, would establish a rule conducive to complicated and repetitive investigations, would render unpredictable the application of § 23 (b) in ordinary commercial affairs, would result in inconsistencies in the application of the term "interest"

in other branches of the tax law, and would amount to judicial legislation.

The Tax Court erred in applying to the construction of the statute principles at variance with the above.

V. The Tax Court did not apply the correct rule of law and its decision is not entitled to finality under the *Dobson* case.

TALBOT MILLS,
Petitioner for Review,
by MELVILLE F. WESTON, *Counsel.*

[fol. 93] On November 8, 1944, this cause came on to be heard, and was fully heard by the Court, Honorable Calvert Magruder, Honorable John C. Mahoney, and Honorable Peter Woodbury, Circuit Judges, sitting.

Thereafter, to wit, on December 22, 1944, the following opinion of the Court and Dissenting Opinion were filed:

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT, OCTOBER TERM, 1944

No. 4015

TALBOT MILLS, Petitioner, for Review,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Petition for Review of Decision of the Tax Court of the United States

Before Magruder, Mahoney and Woodbury, JJ.

Melville F. Weston, Powers & Hall, for Petitioner.

Samuel O. Clark, Jr., Assistant Attorney General; Sewall Key, J. Louis Monarch, Harry Baum, John F. Costelloe, Special Assistants to the Attorney Geenral; J. P. Wenchel, Chief Counsel; Charles E. Lowery, Special Attorney, Bureau of Internal Revenue, for Respondent.

OPINION OF THE COURT—December 22, 1944

MAHONEY, J.:

In its income and excess profits tax returns for the fiscal year ending September 30, 1940, the taxpayer, Talbot Mills, deducted the sum of $40,000 accrued as interest upon certain "registered notes." The Commissioner of Internal Revenue disallowed the deduction on the ground that it did [fol. 94] not represent interest within the meaning of § 23(b) of the Revenue Act of 1938 (52 Stat. 447, 26 U. S. C. A. Internal Revenue Act, p. 1012). The Tax Court of the United States sustained the determination of the Commissioner and concluded "that the 'registered notes' were more in the nature of a capital investment than a loan to the

corporation and payments made as 'interest' are not deductible." The petition for review presents the question whether the payments were dividends or interest.

The taxpayer is a Massachusetts corporation engaged in the manufacture of woven woolen and worsted fabrics. It keeps its books and files its tax returns on the accrual basis. Prior to the beginning of its fiscal year ending September 30, 1940, the taxpayer had outstanding 5,000 shares of $100 par common stock, or a total capital stock of $500,000, and a surplus appearing on its books of $472,754.18. The stock was held by fifteen stockholders who, with the exception of one holder of ten shares to qualify as a director, were either members of the Talbot family, or trusts created by such members. For several years prior to 1937 the taxpayer had been operating at a loss, and in that year the question of liquidation was up for discussion among the stockholders. They decided to stay in business and to take steps towards improving their "competitive condition" such as renovation of the plant and a drastic reorganization of personnel. The possibility of recapitalization was also discussed at that time, and in 1939 the treasurer was authorized "to retain counsel to examine the capital structure of the company with the view to seeing if any modification can be made in same to the advantage of the company." In September of that year a plan of reorganization was submitted to and adopted by the directors, and on September 29, 1939, it was adopted unanimously by the stockholders. Under the plan each stockholder was to surrender four-fifths of his stock in exchange for "registered notes" of a face amount equal to the par value of the stock [fol. 95] surrendered. Pursuant thereto the fifteen stockholders turned in $400,000 of the outstanding $100 par value capital stock, and each received in exchange a share of the $400,000 in notes proportionate to the amount of stock he turned in.

The notes are dated October 2, 1939, and mature December 1, 1964. They provide for interest at an annual rate, ranging from a minimum of 2% to a maximum of 10%, dependent upon the taxpayer's annual earnings.[1] Interest is

[1] "Interest hereon shall be payable annually on December 1 of each year for and on account of the fiscal year of the corporation ended last previous to such December 1, the first such date for the payment of interest being December

[fol. 96] payable December 1 of each year. Payment may be deferred, however, by the directors when the condition of the company warrants such action. No dividends are to be paid on the stock while interest due on the notes remains unpaid. In the event of bankruptcy, receivership, disolution or liquidation, principal and interest are to become immediately due with interest at 6% from the close of the preceding fiscal year. The directors, however, may subordinate the notes "as to both principal and interest

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1, 1940 at a rate which shall not exceed 10 per cent nor be less than 2 per cent and, subject to these limitations, shall be a rate computed as follows: There shall be taken a sum equal to two-thirds (⅔rds) of the net earnings of the corporation for the fiscal year ended last previous to such December 1, computed in accordance with the regular bookkeeping methods and practices of the corporation as established from time to time in good faith by its directors and officers but without deduction for federal income taxes paid or accrued and without deduction for interest upon these notes, and the rate of interest shall be the rate, figured to the nearest one-quarter per cent (¼%) which such sums would represent as interest upon an assumed principal sum of Four Hundred Thousand ($400,000) Dollars. Provided, nevertheless, that from and after the close of the fiscal year ended next previous to December 1, 1964, and for such further time as this note shall remain unpaid, interest shall be at the rate of six per cent (6%) per annum, and such interest to December 1, 1964, shall be included in the installment payable at that date.

The corporation shall have the power, by vote of its Board of Directors, to defer the payment of all or part of any annual installment of interest for such time as the directors may in good faith determine to be necessary by reason of the condition of the corporation, without incurring liability for interest upon such deferred installment of interest, provided that such suspension of payment shall in no wise relieve the corporation of the obligation to pay the amount suspended at some future time and shall in no event operate to defer payment beyond December 1, 1964. The corporation covenants that it will pay no dividends upon any shares of stock of the corporation unless and until all then due interest upon these notes, including interest which may have been postponed as aforesaid, shall have been paid in full."

to any other indebtedness of the corporation maturing not later than December 1, 1964." The corporation may retire the notes at par plus accrued interest at any time unless otherwise provided in any subordination agreement. No mortgage to secure any obligation maturing after December 1, 1964, other than a purchase money mortgage, may be made while the notes are outstanding without the consent of the holders of three-fifths in amount of the notes. With the consent of the holders of three-fifths in amount, the corporation may alter any of the terms of the notes; provided that no such change shall extend the maturity date for the principal, alter the rate or method of computing the rate of interest, or effect any existing subordination agreement. The notes are transferable by endorsement, and some $6,800 of them have changed hands, all transfers, however, being within the close family circle.

At meetings of the board of directors on October 10, 1939, and November 27, 1939, shortly after the plan had gone into effect, the "registered notes" were subordinated to two loans from one bank of $50,000 bearing interest at 4% and $30,000 bearing interest at 3%, a loan of $50,000 bearing interest at 4% from a second bank, and a loan of $100,000 bearing interest at 6% from a third creditor.

On November 27, 1940, the taxpayer's treasurer reported to the directors that he had fixed at 10% the rate of interest for the fiscal year ending September 28, 1940, a rate less [fol. 97] than that computable with reference to the net earnings under the terms of the notes but being the maximum there provided.

The question resolves itself into what is the proper characterization of the payments. Are they interest and as such deductible under § 23(b),[2] or are they dividends[3] and as

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[2] 26 U. S. C. § 23.

"In computing net income there shall be allowed as deductions:

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness."

[3] § 115.

"(a) *Definition of Dividend.*—The term 'dividend' . . . means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year."

such not deductible? So-called interest, here paid to the stockholders who are also the holders of the "registered notes," may be essentially dividends and not interest if it is regarded as the further distribution of profits. We must also consider the character of the security under which payment is made. Modern corporate practice evidences many departures from the older concepts and forms, and the modern use of many hybrid types of security has been accompanied by an increasingly loose use of terminology in the characterization of the particular security. Conditioned by one set of factors preferred stock may go by the name of bonds and notes, and in other circumstances we may encounter notes and bonds going by the name of preferred stock. Whatever the circumstances the basic question whether the payees are creditors or stockholders, and whether the payments are interest or dividends turns on the consideration of all the relevant facts. *Commissioner* v. *Meridian & Thirteenth Realty Co.*, 132 F. (2d) 182 (C. C. A. 7th, 1942); *Eastern Gas & Fuel Associates* v. *Commissioner*, 128 F. (2d) 369 (C. C. A. 1st, 1942); *Commis-*
[fol. 98] *sioner* v. *Schmoll Fils Associated, Inc.*, 110 F. (2d) 611 (C. C. A. 2nd, 1940); *Commissioner* v. *Proctor Shop, Inc.*, 82 F. (2d) 792 (C. C. A. 9th, 1936); Mertens, *Law of Federal Income Taxation*, sections 9:24 and 26:10.

In the *Proctor Shop* case, *supra*, the court observed that "none of the decided cases lay down any comprehensive rule by which the question presented may be decided in all cases, and 'the decision in each case turns upon the facts of that case,' * * * In each case it must be determined whether the real transaction was that of an investment in the corporation or a loan to it. * * * The real intention of the parties is to be sought and in order to establish it evidence aliunde the contract is admissible." The taxpayer in the instant case is a small "family corporation" with fifteen stockholders. The issuance of the notes brought no new capital into the corporation. They represent a mere exchange of stock for notes which did not affect in any material way the previously existing interest of the stockholders. Each retained the same proportionate right to participate in the profits of the business. The subordinable notes bore a variable rate of interest dependent on earnings, and what each stockholder might not get as "interest" he gets as dividends. The stockholders, moreover, retain their same proportionate control of the corporation as owners.

The taxpayer admits that tax avoidance was an important factor in this exchange, and the Tax Court found that it was "the only substantial purpose motivating the transaction." The taxpayer contended that there were further advantages, the reduction in equity control which enabled a concentration of control to affect stable management, and the providing of an investment, negotiable and more readily saleable than the stock of this closely held corporation. The Tax Court dismissed the first, saying that "each shareholder retained the same precise voice in the management he had before the transaction." As for the negotiability [fol. 99] feature, the notes could be subordinated to creditor claims and were. They contain restrictive provisions, and the payment of interest may be deferred. The rate of return is indeterminate. The few notes negotiated remained in the family circle, and the Tax Court has questioned their saleability. We think that the Tax Court properly found "that what the parties really intended to create was a security retaining the profit-sharing advantage of stock, leaving intact their voice in the management, but extending a tax advantage to the corporation not possible in stock," and that there was no proper indebtedness. To hold the contrary would be exalting form above substance.

The taxpayer contends that the language quoted from the *Proctor Shop* case, *supra*, with respect to "evidence aliunde the contract" has been "misused." He concedes that such use was proper in *Arthur R. Jones Syndicate* v. *Commissioner*, 23 F. (2d) 833 (C. C. A. 7th, 1927), where a stock device was used to conceal a usurious loan and "dividends" paid on such stock were held deductible interest; and in *Wiggin Terminals, Inc.* v. *Commissioner*, 36 F. (2d) 893 (C. C. A. 1st, 1929), where "dividends" paid on preferred stock issued to creditors to hold only until through dividends they had received a 100% bonus on a loan were held deductible interest. We have been referred to no case holding that the court could not look to "the actualities of the situation" in determining whether corporate distributions were in fact true dividends or interest on indebtedness. See Healy concurring in *Pacific Southwest R. Co.* v. *Commissioner*, 128 F. (2d) 815, 819 (C. C. A. 9th, 1942).

In *Commissioner* v. *H. P. Hood Sons, Inc.*, 141 F. (2d) 467 (C. C. A. 1st, 1944), this court sustained the Tax Court's determination that cumulative interest payments on 7% income debentures were deductible interest and said: "Al-

though the annual return on the instrument was payable 'only out of and to the extent of the net earnings' that pro-
[fol. 100] prietary feature is subordinate to the indebtedness feature calling for payment of all accumulated unpaid interest on the due date 'whether or not the available net earnings of the company are sufficient for such payments.' " In that case the debentures provided for a fixed rate of interest, the annual payment of which only was contingent upon the extent of the net earnings. There the taxpayer bound itself to pay on the maturity date "the face amount of the instrument together with 'all accumulated and/or accrued and unpaid interest' at the designated rate" of 7%. The taxpayer in the present case has not contracted to pay a fixed rate of interest regardless of whether or not its net earnings are sufficient. The payment of interest is deferable as in the *Hood* case, and in addition to that the rate itself is a variable rate ranging from 2% to 10% depending upon earnings, and it is determined at the end of the fiscal year. The rate is thus not fixed in advance, and until fixed it is contingent. "Stockholders have no absolute right to dividends until they are declared. A creditor has a right to his interest in any event." *Commissioner* v. *Meredian & Thirteen Realty Co., supra.* Here the determination of the rate of interest is geared to the making of profits by the taxpayer, and the note holder does not know in advance what the rate will be. It cannot be said of him therefore that he has a right to his interest "in any event" since he will not know until the end of the fiscal year what the rate will be, and the fixing of the rate is a condition precedent to the determination of the amount of interest due. In the light of all the facts in the case the provision that minimum and maximum rates have been set is not controlling. The notes authorize the directors to suspend the payment of interest when the needs of the business require such action. No provision is made for interest to be paid on such suspended payments, and they are subjected to the risks of the enterprise. These factors taken in con-
[fol. 101] junction with the provisions for subordination to the claim of creditors and the straight exchange feature of the transaction leaving the proportionate interests of the stockholders unaffected move us to conclude on the reasoning of the *Hood* case, *supra*, that the indebtedness feature is subordinate to the proprietary feature and to hold that

the "interest" on these notes is not "interest on indebtedness' deductible under § 23(b).

The question here presented turns on its special facts. We believe that the Tax Court was correct in holding that the payments made as "interest" were not deductible, and its decision must stand. *Dobson* v. *Commissioner*, 320 U. S. 489 (1944) rehearing denied 321 U. S. 231.

The decision of the Tax Court of the United States is affirmed.

MAGRUDER, J. (dissenting):

I do not regard as decisive the fact that the so-called "interest" to be paid on the "registered notes" is a variable rate contingent upon the amount of the corporation's net earnings. This feature, the government insists, is "the paramount proprietary characteristic" differentiating the equity interest of a shareholder from the debtor-creditor relationship. It has long been settled in the law of partnership that one may lend money to the proprietor of a business upon an agreement for the payment of interest not at a predetermined fixed rate but in a variable amount ascertained by reference to a percentage of the net profits, without thereby becoming a partner in the business and liable as a coproprietor for the business debts. See *Meehan* v. *Valentine*, 145 U. S. 611, 624 (1892). In the case of such a loan, the return paid to the lender under the agreement, though variable in amount from year to year, would surely [fol. 102] constitute "interest" within the meaning of § 23(b) of the Internal Revenue Code, since it would be the agreed "compensation for the use or forbearance of money." *Deputy* v. *du Pont*, 308 U. S. 488, 498 (1940).

Of course, the lending of money is not the only way an indebtedness may arise upon which interest is to be paid. Thus, upon the sale of goods, the buyer may agree to pay interest on the unpaid installments of the purchase price, and it may be provided that this interest shall be variable in amount contingent upon earnings. This would be deductible under § 23(b) quite as much as if the purchase money had been paid over to the seller and then lent back to the buyer.

And so, it is possible for a corporation to create an "indebtedness,' within the meaning of § 23(b), by an agreement under which the corporation redeems some of its stock

at par, and instead of paying cash therefor gives to the surrendering shareholders interest-bearing notes for the redemption price. The exchange of stock for notes would give rise to an "indebtedness," even though no new capital were thereby brought into the corporation.

The result would be no different if we assume that the main motive for the recapitalization was to achieve a tax advantage. *Commissioner* v. *H. P. Hood & Sons, Inc.*, 141 F. (2d) 467, 471 (C. C. A. 1, 1944). To test this, suppose that, at the organization of the corporation, the fifteen individuals who were to put up the money had considered the alternatives of having the corporation issue to them 5000 shares of stock at $100 a share, or 1000 shares of stock and ordinary interest-bearing notes in an amount of $400,000; and had decided on the latter course in order to give the corporation the advantage of the interest deduction under § 23(b). This advantage would have been achieved had they chosen the second alternative at the outset. Yet the [fol. 103] proportionate voting control of the original shareholders would have been the same either way, and their returns in the aggregate might have been the same either way—under the first alternative received solely as dividends, under the second partly in the form of dividends and partly as interest. If interest deductibility could be achieved by an original capitalization as above supposed, it could equally well be achieved by a subsequent recapitalization along the same lines.

Therefore I think we should lay aside as irrelevant two points stressed in the opinion of the Tax Court: (1) "The factor of tax avoidance loomed large in the minds of the parties by their own admission, and indeed appears to have been the only substantial purpose motivating the transaction"; and (2) "Each shareholder retained the precise voice in the management which he had prior to the transaction. He retained the same right to participate in the profits of the business; what he did not receive by way of interest he would take by way of dividends on his remaining stock."

Whether the registered notes are to be classified as evidences of indebtedness depends upon an analysis of their substantive provisions, not upon who holds them. It is not suggested that the notes are a sham, that is, that they do not embody the real understanding of the parties to the transaction. If the notes would have been evidences of in-

debtedness in the hands of outsiders, they are equally so in the hands of the group who also hold the outstanding stock. And if the notes would have been evidences of indebtedness had some of the original shareholders surrendered all their shares of stock in exchange for the notes, they cannot be anything different merely because each of the original shareholders surrendered four-fifths of his shares in exchange for a proportionate part of the notes, thereby leaving unaffected the relative voting control.

[fol. 104] From the foregoing I think it is clear that, had the notes in the present case been simple promissory notes in the conventional form, unencumbered by the special provisions which have been set forth in the opinion of the court, the amounts annually paid thereon would have been deductible as "interest * * * on indebtedness."

The special provisions in the notes do not require different conclusion. The provision for subordination is no novelty in debtor-creditor agreements. It happens to be the fact that, at the date of the hearing before the Tax Court, all the subordinations had been terminated by the payment of the obligations. In the event of bankruptcy, the holders of the notes would have provable claims *pari passu* with the other general creditors. As already indicated, the provision for a variable rate of interest, from a minimum of 2% to a maximum of 10%, depending on earnings, is wholly consistent with the existence of an indebtedness, and indeed provisions of that general type are not uncommon in debt-creating instruments. See *Meehan* v. *Valentine*, 145 U. S. 611 (1892); *Edwards* v. *Bay State Gas Co.*, 91 Fed. 946 (C. C. D. Del., 1898). The minimum of 2% is not contingent upon earnings, and payment of this 2% by the corporation would certainly not be in violation of provisions in the various corporation laws against payment of dividends out of anything but earnings or surplus. True, the corporation under certain conditions may defer the payment of the stipulated interest, not, however, beyond the maturity date of the principal. This, again, is a proper matter of agreement between debtor and creditor.

In other words, the notes are characteristic evidences of indebtedness, in that (1) they contain an unqualified obligation to make a fixed principal payment on a day certain (which may be accelerated under certain conditions, but

[fol. 105] not postponed);[1] (2) they carry no voting power or voice in management of the obligor's business;[2] and (3), at least outside the field of taxation, the notes would be given effect according to their terms, and the holders of the notes would have the recognized status of creditors.

Of course, Congress might restrict the deduction for interest to cases where interest is payable at a fixed rate irrespective of earnings. This is exclusively a matter of legislative policy. So far, no such restriction has been put into the Act. The courts are bound by the unqualified statutory command in § 23(b) that deduction shall be allowed for "*all interest* paid or accrued within the taxable year on indebtedness" [italics added]—with one exception not now relevant.

In the case at bar, there is no disputed question of fact relevant to the issue to be decided. The terms of the notes speak for themselves, and their legal effect, that is, whether they constitute evidences of "indebtedness" within the meaning of § 23(b), is a question of law. This is not even the kind of legal question with which the Tax Court may be assumed to have specialized familiarity, for the legal effect of the instruments as constituting an indebtedness may arise in many ways outside the tax field, and there is no indication that Congress meant the word "indebtedness" to have any peculiar meaning in § 23(b). Congress has given the circuit courts of appeals authority to modify or reverse decisions of the Tax Court if "not in accordance with law" (44 Stat. 110). The reports of the Senate and [fol. 106] House committees state pretty clearly what Congress meant by that; one of the "questions of law" which the reports say courts may consider on review is "the proper interpretation and application of the statute or any regulation having the force of law." H. R. Rep. No. 1, 69th Cong., 1st Sess. (1925), p. 19; Sen. Rep. No. 52, 69th Cong.,

[1] To further assure the fulfillment of this obligation, the notes provide that no corporate mortgage shall be made to secure an obligation maturing later than the due date of the notes, and that no subordination agreement shall extend beyond such due date.

[2] If the original shareholders should transfer their remaining shares of stock, they would cease to have any voting power in the corporation, though they still held on to the notes.

1st Sess. (1926), pp. 36-37. Prior to *Dobson* v. *Commissioner*, 320 U. S. 489 (1943), the circuit courts of appeals would certainly have been considered free to make an independent review of issues such as that in the present case. *Helvering* v. *American Dental Co.*, 318 U. S. 322 (1943); *Powers* v. *Commissioner*, 312 U. S. 259 (1941). I think the reviewing courts should continue to assume that this is so, until the Supreme Court explicitly tells us otherwise. The *Dobson* opinion, to my reading, contains no such explicit direction. *Cf. Security Flour Mills Co.* v. *Commissioner*, 321 U. S. 281 (1944); *Norton* v. *Warner Co.*, 321 U. S. 565, 569 (1944).

Such being my view, with all deference I dissent from the opinion and judgment of the court.

On the same date, to wit, December 22, 1944, the following Final Decree was entered:

FINAL DECREE—December 22, 1944

This cause came on to be heard November 8, 1944, upon the record on petition for review of a decision of The Tax Court of the United States, and was argued by counsel.

Upon consideration whereof, It is now, to wit, December 22, 1944, here ordered, adjudged and decreed as follows: The decision of the Tax Court of the United States is affirmed.

By the Court,

(S.) Arthur I. Charron, Clerk.

[fol. 107] Thereafter, to wit, on January 8, 1945, mandate issued.

Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 108] SUPREME COURT OF THE UNITED STATES

ORDER ALLOWING CERTIORARI—Filed April 30, 1945

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the First Circuit is granted, and the case is transferred to the summary docket and assigned for argument immediately following No. 948, The John Kelley Co. v. Commissioner of Internal Revenue.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.